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Sales Tax Reform in Ontario: The Time is Right

By
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- Putting an end to Ontario's archaic retail sales tax and adopting a value-added tax like the GST would sharply lower the effective tax rate on new business investment and offer the province a much-needed economic boost.
- Beginning in the near term, competitive market pressures will ensure that businesses pass through tax savings to consumers, and provide an incentive to speed up investment in new plant, equipment, processes and people.
- Concerns over the effects of a revamped tax system, particularly when it comes to low-income families, can easily be dealt with through targeted credits and enhancements to the family benefits that are already part of the tax system.

Canada's federal government, since implementing the Goods and Services Tax in 1991, has repeatedly urged the provinces to reform their own antiquated retail sales taxes. New Brunswick, Nova Scotia and Newfoundland and Labrador did so in 1997, by signing on to the Harmonized Sales Tax (HST), which the federal government administers on their behalf.[1]

Ontario's economic outlook would much improve if the province now joined in, by eliminating the province's destructive retail sales tax. The time is right because the province's need for long-term thinking about how to improve the investment environment, and the outlook for productivity, wages and jobs, has never been clearer.

Were Ontario to eliminate its retail sales tax and adopt a fairer value-added tax, such as the GST, construction investment would increase, as would business spending on machinery and equipment. The reason is that the tax burden on business capital investment would drop significantly. Labour productivity would improve, and with it workers' wages. The province's economic potential, including export sales, would improve permanently by half a percentage point – a tremendous boost in provincial income.

After discussing the economic benefits of reform, now, in Ontario, this *e-brief* examines typical objections to reform, including concerns about the speed with which those benefits would flow, the impact of reform on consumer prices and on low-income families as well as particular business sectors. In each case, I outline policy responses that would mitigate the perceived downsides to change.

1 Quebec at the same time adopted its own GST-compatible tax, which it administers alongside the federal GST.

INDEPENDENT • REASONED • RELEVANT

Beneficial Economic Impact

By eliminating most provincial tax on business inputs,[2] Ontario's switch to a value-added base would dramatically lower its effective tax rate on new business investment. In 2012, post-reform, the province's effective tax rate on capital investment would be 21.8 percent, as opposed to 31.9 percent absent reform. The difference moves Ontario from being an extraordinarily high tax jurisdiction, within North America, to being a medium-tax jurisdiction (Figure 1).

With what impact on real investment? The 1997 HST reform in the eastern provinces drove a pop in investment, measured on a per capita basis, of 11.1 percent, an extremely large and statistically significant impact (Smart 2007). Assuming an Ontario GST introduced under current market conditions at a 7.5 percent rate, the positive impact on investment in nonresidential construction would grow slowly to four percent annually (Dungan et al. 2008). The boost to machinery and equipment investment would level out at above three percent annually (Table 1).

A SHORT-TERM INVESTMENT RESPONSE: How quickly will the positive investment impact arrive? Post-reform competitive price pressure would tend to drive capital stock renewal at a pace faster than its usual cycle. The impact of lowering the tax rate on business investment makes itself felt through lower-than-otherwise consumer prices as the economy's stock of machinery, plant and equipment grows. Further, ordinary competitive market pressure, in a small open economy such as Ontario's, will drive businesses to adjust quickly in response, so that the economic benefits quickly materialize through new business investment. Faster growth, delivered even sooner than suggested in Table 1, is a likely outcome.

GIVE AND TAKE FROM OTTAWA: Sales tax reform in Ontario will be a key step in improving the nation's economic union. The positive growth impacts of Ontario's reform will increase federal tax revenue in Ontario, and in other provinces too, making possible a federal financial contribution to ease the change into place. The federal gain will grow slowly, rising over time from about $500 million to $2 billion annually (Table 1), which indicates the scale of support Ottawa could supply the provincial government while making roughly whole the federal fiscal balance.

Addressing Concerns with Smart Policy

Given that improved business investment incentives and near-term growth outlook is obviously in Ontario's immediate interest, what could be the objections to reform? Typical examples are concern over whether business savings from a lighter tax on inputs would flow through to consumers, concern whether a GST-like tax would be harder on poor households than rich ones, and worries about impacts on business sectors whose products would be newly exposed to provincial value-added taxation.

Considering each in turn suggests that these concerns can be addressed through simple policy moves, and that negative outcomes are improbable under current circumstances.

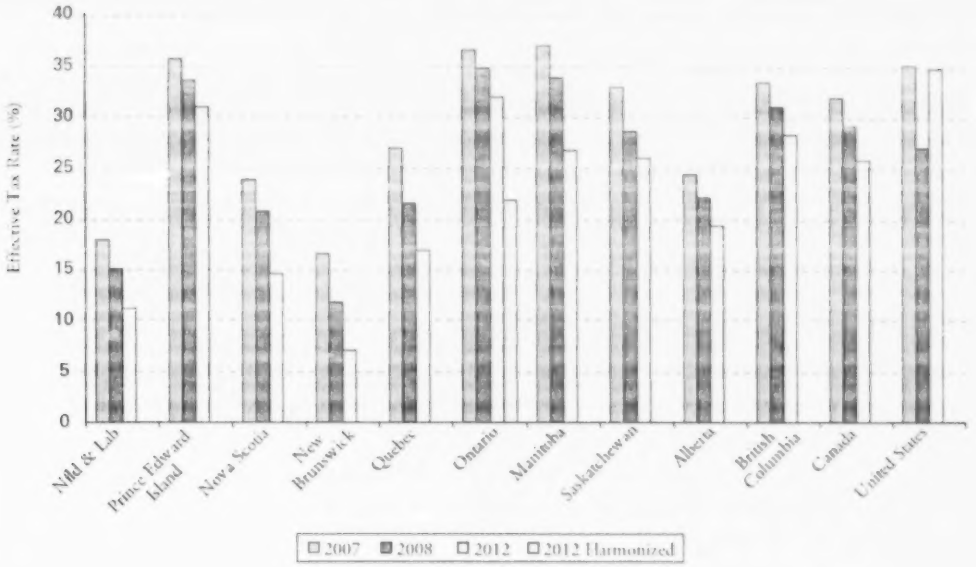
Concern One: Impact on Consumer Prices

One good way to estimate reform's impact on consumer prices is to examine the precedents. The eastern Canadian experience with moving to the HST is the obvious example. Provincial retail sales taxes were replaced with a slightly broader tax on goods and services, applied at a lower rate.[3]

2 Under Ontario's retail sales tax, businesses are taxed on many of their intermediate inputs and capital goods, which cascades into higher consumer prices for products that have multiple stages of production in the province, and makes exports less competitive. Under a value-added tax like the GST, businesses credit the taxes they pay against GST collected on their sales, and remit the difference.

3 The eastern provinces received generous federal financial support that enabled them to bring down the combined, post-reform HST rate.

Figure 1: Marginal Effective Tax Rates on Capital Investment: 2007, 2008 and 2012



Source: Chen and Mintz, 2008.

Table 1: Effects of RST-GST Harmonization in Ontario at Provincial Rate of 7.5%, Given Current Outlook

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 10
	Percentage Change					
Real provincial product	0.0	0.2	0.2	0.2	0.2	0.5
Private investment	1.2	2.3	2.5	2.2	1.9	1.9
Residential construction	-0.1	0.2	0.3	0.0	-0.2	-0.1
Nonresidential construction	1.4	2.8	3.3	3.3	3.3	4.1
Machinery and equipment	2.4	4.2	4.3	3.8	3.5	3.1
Exports	0.0	0.1	0.3	0.4	0.4	0.5
International exports	0.0	0.2	0.3	0.5	0.6	0.7
Exports to the rest of Canada	0.0	0.1	0.1	0.1	0.1	0.1
Imports	0.1	0.3	0.4	0.4	0.4	0.4
Real capital stock	0.1	0.5	1.0	1.4	1.6	2.4
Federal tax revenue impact in Ontario						
($ millions)	262	547	809	869	966	1,963
Provincial tax revenue impact						
($ millions)	-952	-938	-1,130	-1,501	-1,877	-3,737

Note: Effects are percentage change from the base case, unless otherwise indicated.

Source: Dungan, Mintz, Poschmann and Wilson (2008).

After those 1997 changes, competitive markets delivered exactly what should be expected: shelter costs and clothing and footwear prices rose, as items which previously had been exempt from sales tax became taxable; the prices of some things, like household operations and health and personal care, fell more than others; and overall consumer prices fell by an amount roughly commensurate with the overall tax rate decline (Smart 2007).

The message bears special importance to Ontario today, where concern might arise over the prospect of taxing more goods and services at the existing 8 percent sales tax rate. After all, if businesses failed to pass on savings, or the tax change was perceived as a general increase in consumer prices that would trigger upward pressure on wages, and thereafter higher interest rates from the Bank of Canada, the economic impact could be negative.

We now know, however, that savings indeed are passed on in competitive markets and, furthermore, under current market conditions there is no chance of tax-driven inflationary expectations evolving and no prospect of a restrictive Bank of Canada response.

Concern Two: Adverse Distributional Effects

Some Ontarians have expressed concern over broadening the sales tax base to cover items like books, home heating fuels and children's clothing, which are generally exempt from provincial retail sales tax but not from the GST. Might these impacts adversely affect low-income households' ability to spend on these items?

This is a misplaced worry, as experience with the GST shows. Extending offsetting low-income credits through the income tax system is simple, and in Ontario's case could be done with minor dollar-figure changes to the provincial tax return.

It is a matter of fairness and economic common sense that this concern – the ability of low-income households to pay the GST on things that form a relatively large share of their household spending – be dealt with through low-income credits or family benefits and not by exempting particular goods and services. The reason is that home heating fuels and children's clothing, for example, are consumed by households of all income levels, and not just the poor. Enhancing provincial family benefits is the better route to cushioning any unwanted distributional impacts.

Concern Three: Sectoral Impacts

Some sectors, such as financial services and new residential construction, produce outputs that are not taxed under the provincial retail sales tax but would be under a GST or similar value-added tax, implying that reform could inflict sudden harm on these businesses.

Simple design changes would mitigate the potentially adverse affects of such shocks. Most financial services are exempt from the GST – no tax is applied to sales and no refund is provided for taxes paid on inputs. This is not necessarily the best option, because it distorts the market by embedding tax in the cost of providing financial services. Ontario could be wiser to either (i) tax financial services provided to households, and "zero-rate" business services, while allowing credits for all tax paid on inputs; or (ii) follow Quebec's approach, zero-rating sales of financial services while disallowing input credits for some business purchases.

Shocks to the real estate market sector are even easier to mitigate. The federal system offers a phased rebate that reduces GST payable for new houses selling for less than $472,500. That threshold has not moved since the GST's introduction: a considerably higher rebate threshold could apply federally and provincially. Ontario could further reduce any GST-induced shock to the housing market by eliminating its inefficient Land Transfer Tax, which is an impediment to economically rational resource allocation.

Closing the Deal

Ontario workers, employers and consumers, not to mention the rest of Canada, would benefit from an Ontario government decision to implement sales tax reform, and to do so without hesitation. The province sorely needs near-term and long-term boosts to its growth and investment outlook, which sales tax reform, with appropriate policy fine-tuning, can deliver.

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